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Nos. 84-871, 84-889, 84-1054, and 84-1069

IN THE

Supreme Court of the United States

October Term, 1985

Louisiana Public Service Commission

Appellant

v.

Federal Communications Commission and United States of America

Appellees

California and Public Utilities Commission of California, et al.

Petitioners

v.

Federal Communications Commission and United States of America

Respondents

Public Utilities Commission of Ohio, et al.

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v.

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Florida Public Service Commission

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On Appeal And On Petitions For A Writ of Certiorari To The United States Court of Appeals For The Fourth Circuit

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BRIEF OF THE UNITED STATES TELEPHONE ASSOCIATION, AS *AMICUS CURIAE*, IN SUPPORT OF THE APPELLEES AND RESPONDENTS

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BRIEF OF THE UNITED STATES TELEPHONE ASSOCIATION, AS *AMICUS CURIAE,* IN SUPPORT OF THE APPELLEES AND RESPONDENTS

The United States Telephone Association ("USTA") submits this brief as amicus curiae, pursuant to Rule 36 of the Rules of this Court in support of appellees and respondents Federal Communications Commission ("FCC" or "Commission"), *et al.*, urging affirmance of the judgment of the United States Court of Appeals for the Fourth Circuit in *Virginia State Corp. Commission* v. *FCC,* 737 F.2d 388 (4th Cir. 1984), *Motions for Hearing En Banc Denied*, Oct. 3, 1984 ("VSCC"). In this decision, the Court of Appeals affirmed an order of the FCC preempting inconsistent state regulation of depreciation rates and classes of property. *Amendment of Part 31, Uniform System of Accounts and Petition for Declaratory Ruling on Questions of Federal Preemption*, 92 F.C.C.2d 864 (1983) ("1983 Preemption Order"), *on reconsideration of* 89 F.C.C.2d 1094 (1982) ("1982 Preemption Order"). USTA seeks to demonstrate below why the Fourth Circuit's judgment should be affirmed.[1]

INTEREST OF THE *AMICUS CURIAE*

The United States Telephone Association is the national trade association of the telephone exchange carrier industry. Its members include telephone companies in every state and serve over 99% of this nation's telephone access lines.

The FCC regulations at issue in this proceeding vitally affect the interests of USTA's members. The adequate and timely capital recovery fostered by federal preemption of inconsistent state regulation of depreciation rates and methods is essential to the financial well-being of the USTA membership. While some of USTA's larger members are parties to this proceeding, the majority are not. Thus, the views of many telephone companies would not be heard but for USTA's participation as an amicus curiae. The purpose of this brief is to provide the Court with an awareness of the economic facts which underlie and justify the FCC's decision to preempt inconsistent state depreciation regulation.

[1]This brief is submitted upon the written consent of all parties, copies of which are filed herewith.

SUMMARY OF THE ARGUMENT

The question before this Court is whether the Court of Appeals correctly held that the FCC acted within the scope of its authority in determining that its prescription of certain depreciation practices for telephone equipment preempted state commissions from prescribing inconsistent depreciation practices. The Court of Appeals' decision is correct. Congress, the courts, and the FCC have established a national policy in favor of encouraging the provision of modern, efficient nationwide communication service at reasonable rates and the provision of new technologies and services to the public. This policy displaces all inconsistent state regulation. The assurance of adequate capital recovery for telephone companies is critical to the accomplishment of this federal policy. The FCC properly found that inconsistent state regulation would frustrate that policy. Based upon principles reinforced in the Court's recent unanimous decision in *Capital Cities Cable, Inc.* v. *Crisp,* 104 S. Ct. 2694 (1984), the FCC's *1983 Preemption Order* is valid and should be affirmed.

ARGUMENT

I. ADEQUATE AND TIMELY CAPITAL RECOVERY IS ESSENTIAL TO THE IMPLEMENTATION OF NATIONAL POLICY

During the last forty years, a near-revolutionary change has occurred in the telephone industry as a result of tremendous technological developments. *See, Third Computer Inquiry,* FCC 85-397, slip op. at 2, 14 (Aug. 16, 1985). Spurred by these technological developments, and recognizing that the promotion of competition is a legitimate means of meeting the FCC's mandate under Section 1 of the Communications Act of 1934 "to make available,... a rapid, efficient, Nation- wide,... wire and radio communication service with adequate facilities at reasonable charges...", 47 U.S.C. § 151, both the FCC and the courts have rendered numerous decisions encouraging the develop-

ment of competition[2] as a means of achieving important public benefits such as enhanced technological innovation, lower consumer rates, and an increase in the diversity, quality, and efficiency of telecommunications equipment and service offerings. *See, e.g., United States* v. *AT&T*, 552 F. Supp. 131 (D.D.C. 1982), *aff'd sub nom. Maryland* v. *United States* 460 U.S. 1001 (1983). As a result, a technologically advanced competitive environment pervades the telecommunications marketplace in the United States.

[2]The FCC and the courts have rendered numerous decisions promoting competition in the provision of telephone terminal and accessory equipment, long distance telecommunications, and "enhanced" computer/telecommunications services in order to encourage the emergence of numerous new telecommmunications services and providers. *See, e.g., MCI Telecommunications Corp.* v. *FCC*, 561 F.2d 365 (D.C. Cir. 1977), *cert. denied*, 434 U.S. 1040 (1978), and *MCI Telecommunications Corp.* v. *FCC*, 580 F.2d 590 (D.C. Cir. 1978), *cert. denied*, 439 U.S. 980 (1978); *Microwave Communications, Inc.*, 18 F.C.C.2d 953 (1969), *on reconsideration*, 21 F.C.C.2d 190 (1970); *Hush-A-Phone Corp.* v. *United States*, 238 F.2d 266 (D.C. Cir. 1956); *Proposals for New or Revised Classes of Interstate and Foreign Message Toll Telephone Service (MTS) and Wide Area Telephone Service (WATS)*, 56 F.C.C.2d 593 (1975), *aff'd sub nom. North Carolina Utilities Commission* v. *FCC*, 552 F.2d 1036 (4th Cir. 1977), *cert. denied*, 434 U.S. 874 (1977); *Amendment of Section 64.702 of the Commission's Rules and Regulations (Second Computer Inquiry)*, 77 F.C.C.2d 384, *modified on reconsideration*, 84 F.C.C.2d 50 (1980), *modified on further reconsideration*, 88 F.C.C.2d 512 (1981), *aff'd sub nom. Computer & Communications Industry Ass'n* v. *FCC*, 693 F.2d 198 (D.C. Cir. 1982), *cert. denied*, 461 U.S. 98 (1983); *MTS and WATS Market Structure*, 81 F.C.C.2d 177 (1980); *Policy and Rules Concerning Rates for Competitive Common Carrier Services and Facilities Authorizations Therefor, First Report and Order*, 85 F.C.C.2d 1 (1980), *Second Report and Order*, 91 F.C.C.2d 59 (1982), *reconsideration denied*, 93 F.C.C.2d 54 (1983), *Fourth Report and Order*, 95 F.C.C.2d 554 (1983), *Fifth Report and Order*, 98 F.C.C.2d 1191 (1984), *Sixth Report and Order*, 57 Rad. Reg. (P&F) 2d 1391 (1985), *vacated*, *MCI Telecommunications Corp.* v. *FCC*, 765 F.2d 1186 (D.C. Cir. 1985).

In addition to the FCC, the Department of Justice has promoted a federal policy in favor of competition and open entry. In order to ensure fair competition in the provision of long distance services, information services, and in the manufacturing and distribution of terminal, switching, and transmission equipment, the Justice Department brought an antitrust suit against AT&T which resulted in the company's divestiture. *United States* v. *AT&T*, 552 F. Supp. 131 (D.D.C. 1982), *aff'd sub nom. Maryland* v. *United States*, 460 U.S. 1001 (1983).

The goals sought through the implementation of this national policy promoting technical innovation and network efficiency cannot be reached if telephone companies are threatened with inconsistent regulations that will deny adequate and timely capital recovery. There is a real relationship between adequate and timely capital recovery and the implementation of federal policy, contrary to the arguments of the appellant and petitioners. Brief of Appellant Louisiana Public Service Commission, *et al.* ("Louisiana Brief") at 13-15; Brief of Petitioners State of California and Public Utilities Commission of California, *et al.* ("California Brief") at 26 *et seq.* The receipt of adequate and timely capital recovery is, in fact, essential to the continued provision, by this nation's telephone carriers, of those modern, cost-efficient services and facilities so critical to the effectuation of federal policy. Petitioners fail to recognize the critical link between adequate capital recovery, efficient telephone company operations in a competitive environment, and the effectuation of federal policy. Local telephone companies play a pivotal role in the accomplishment of the federal policy objectives, which presume and require the existence of a modern, basic public switched network. Furthermore, local exchange companies are the only ubiquitous providers of telephone service within their franchised areas. Thus, the facilities of these companies are the vital link between new telecommunications service suppliers and the vast majority of consumers. Moreover, local companies are expected to provide many of the services, and much of the new equipment, now available through competition in the telecommunications marketplace. Therefore, to the extent that inadequate or untimely capital recovery renders local telephone carriers incapable of maintaining a modern public switched network or unable to serve as a competitive source for equipment and services, the accomplishment of the FCC's competitive policy objectives will be frustrated significantly.

Capital recovery is an important issue for telephone companies. Under the principles of rate base rate of return regulation which govern the provision of telephone service in the United States, telephone carriers are entitled to recover, from ratepayers, their legitimate business expenses plus a fair return on the property used in providing service to the public. *See, e.g., Federal Power Commission* v. *Hope Natural Gas Co.*, 320 U.S. 591, 603 (1944). It is well settled that investors are entitled to recoup from ratepayers the full amount of their

investment in depreciable assets devoted to public service. *See Knoxville v. Knoxville Water, 212 U.S. 1, 10 (1909); Democratic Central Committee v. Washington Metropolitan Area Transit Commission*, 485 F.2d 786, 808 (D.C. Cir. 1973) *cert. denied*, 415 U.S. 935 (1974). This capital investment is recovered through annual depreciation charges designed to regain, over the service life of an asset, the entire amount paid by investors to purchase the plant. Federal Communications Commission, *Primer and Overview of Depreciation and Capital Accounting 3 (1980) ("FCC Depreciation Primer")*.[3] These depreciation charges are based on the book cost (*i.e.*, original cost) of the asset. Such book depreciation when combined with the appropriate level of tax depreciation and the investment tax credit, must maintain a balance between the capital invested in the asset and that asset's economic value.[4] Only in this manner can it be assured that depreciation expense matches the revenue an asset generates permitting full recovery of the capital invested while the asset is in service.[5] Upon retirement, the original cost of a plant should be balanced by the total amount in the depreciation reserve and any net salvage realized at retirement. National Association of Regulatory Utility Commissioners, *Public Utility Depreciation Practices* 36 (1968) ("NARUC Depreciation Manual").[6]

Capital recovery is essential to telephone company operations in the new environment because of its effect on a company's ability to provide adequate facilities and competitive services at reasonable rates. Since this was not true in the prior environment, capital recovery was generally sacrificed to keep subscriber rates low. *See, e.g., NTIA Report, supra* note 3, at 137-38; Joseph R. Fogarty, *Capital Recovery: A Crisis for Telephone Companies, a Dilemma for Regulators*, Pub. Util. Fort. 13, 14 (Dec. 8, 1983). This deferral was accomplished through the prescription of unreasonably long service lives,[7] and the use of depreciation methodologies such as the straight-line vintage group method ("SLVG"),[8] and the whole-life method.[9] This practice

[3]Although not a dollar for dollar equivalence, as a consequence of the formula used to set carrier revenue requirements, depreciation expense affects the total amount of a carrier's net operating expense, the size of its rate base, and the actual return realized by the company. *See* Garfield and Lovejoy, *Public Utility Economics*, Chapter 8 (1964); National Telecommunications and Information Administration, *Issues on National Domestic Telecommunications: Directions for National Policy* 137 (1985) ("NTIA Report").

[4]*See*, Griffith and Robinson, *Economic Value and Capital Recovery: A Regulatory Model*, Pub. Util. Fort. 30 (July 11, 1985). The economic (market) value of an asset is the discounted value of the future revenues less the future expenses that an asset is expected to generate. In order to ensure proper economic depreciation, it is necessary that throughout the life of an asset, its net investment (gross investment less recovered capital) equals its then current market value. *Id.*

[5]This is an important protection for ratepayers, as well as investors, since ratepayers are required to reimburse investors for the cost of an asset even when the asset is underdepreciated at the time it is retired from service. When an asset is retired before it is fully depreciated, the loss is passed on to those ratepayers remaining. *See Democratic Central Committee*, 485 F.2d at 810.

[6]The depreciation reserve is the measure of the total accrued depreciation of depreciable assets still in service. Garfield and Lovejoy, *supra* note 3, at 95. Although California is correct that the reserve is not a fund, California Brief at 36, monies in an amount equivalent to the depreciation accruals flow into the general funds of the company and may be used for any purpose of the business including construction.

[7]This over-estimation of lives had the effect of reducing the companies' annual expenses while at the same time adding to the companies' rate bases and allowable earnings. Regulators benefited from this practice because annual revenue requirements were temporarily lower than they otherwise would have been, while companies also benefited because the continued growth on earnings resulting from the larger rate bases made the companies more attractive to investors. *NTIA Report, supra* note 3, at 138-40.

[8]Under the SLVG methodology, all the assets within a category of plant (*e.g.*, telephone cable) placed in service in a single year (vintage), regardless of variations in the useful lives of the plant, were classed together without respect to their individually projected lives and depreciated over the average useful life of the group. *See VSCC*, 737 F.2d at 391.

[9]Whole-life methodology attempted to compensate for changes in estimation of plant service lives by calculating the annual depreciation charge that would have been appropriate if the currently estimated whole-life of the asset had been determined at the onset of the asset's life. Under this procedure, ratepayers are only charged costs equivalent to the *pro rata* portion of the total cost applicable to the time period. Current ratepayers are

(footnote continued)

was defensible in a fully regulated monopoly environment. In the absence of competition, investment was less at risk than it is today. Regulators and companies controlled the introduction of new technology and services, thereby assuring the eventual recovery of all investment. *NTIA Report, supra* note 3, at 138.

Such deferral is no longer possible. With constant technological innovation and the resultant development of competition, costs deferred in the past are not recoverable beyond the economic life of an asset since the revenues that an asset can generate are now dependent more on market conditions than on regulatory control.[10]

The timing of capital recovery and the use of accurate and consistent depreciation methods has become essential to telephone company operations. It is particularly important that in a competitive market, depreciation accounting reflect the economic reality of the company's total operations and total capital requirements to its customers, and investors, as well as to regulators. *Property Depreciation*, 83 F.C.C.2d 267, 281 (1980). Moreover, local telephone carriers must price competitively.[11] Depreciation is an important element in

charged neither costs attributable to past periods nor costs attributable to future time periods.

[10]According to NTIA:

> The growth of competition, the convergence of the communications and computer industries, deregulation, and the quickening progress of technology— which has reduced the economic life of many capital assets—all have combined to diminish the ability of regulators to maintain [the practices which were applicable in the monopoly environment].... None of these practices is desirable under conditions of competition, especially where equipment and service innovations appear rapidly and failure to keep pace can handicap a vital industry.

NTIA Report, supra note 3, at 138.

This is a risk which is of great concern to the investment community and which has clearly negatively affected telephone company cost of capital even in the face of record earnings. *See, e.g.*, Hyman, *Utility Finances 1985*, Pub. Util. Fort. 17, 18 (Feb. 21, 1985).

[11]Local telephone carriers face increasing competition. Due to wide scale industry conversion to electronic digital (*i.e.*, computer based) switching

(footnote continued)

determining the price at which service can be offered by a regulated firm. *See 1983 Preemption Order*, 92 F.C.C.2d at 877. If competition is to be viable, it is necessary for prices to reflect depreciation expenses that are realistic for a competitive market. Most telephone plant is used interchangeably to provide interstate and intrastate communications service and as a result supply and demand for this plant is determined by service demand inputs from both jurisdictions. *Id.* at 271-272. Consequently, it is no longer possible to separate the interstate and intrastate components of depreciation if the public is to enjoy the benefits of competitive pricing.

Depreciation represents a major source of funding for the extremely capital intensive telephone industry. This role will increase as external capital becomes more expensive for telephone companies and as the companies are forced to accelerate their network modernization programs in order to meet competition.[12] Again, given the interchangeability of plant, it is not feasible to divide capital recovery into interstate and intrastate components if federal policy is to be achieved.

equipment during the past several years and the recent introduction of fiber optical transmission technology, the industry's technology base is no longer static. Advances in digital switching technology have actually reduced the cost of switching capacity. As the digital switching technology continues to evolve, further reductions in the cost of replacement capacity can be anticipated. This declining replacement cost function permits potential competitors to purchase operating capacity at a lower cost per unit than the telephone companies' embedded cost per unit, as well as to price these services lower than telephone company offerings. As a result, natural barriers to competition at even the local exchange level are falling. Competitive pricing is required therefore not as a means of permitting local carriers to "drive out new entrants to their markets," California Brief at 37, but as a means of ensuring the fullest degree of competition in the marketplace in order to achieve federal policy objectives.

[12]For example, in 1976, depreciation funds represented 46.5% of construction expenditure funds sources. Bolter & Irwin, *Depreciation Reform-A Crucial Step in Transforming Telecommunications to a Free Market* 93 (1980). In 1984, total telephone industry depreciation expense was $11,816,343,000. This represented 66.4% of total industry gross addition to plant which amounted to $17,774,072,000. United States Telephone Association, *Telephone Statistics 1985* 17, 20 (1985).

At the same time that timely depreciation has become essential to telephone company operations, the current net book value of much plant in service unfortunately is now substantially above its market or economic value as a consequence of technological change and increased competition.[13] In the aggregate, the telephone industry now has approximately a $26 billion deficiency in its depreciation reserves.[14] This reserve deficiency is equivalent to approximately 41% of the companies' equity. The prospect that this enormous amount may never be recovered represents a serious threat both to the telephone industry and to its customers.[15]

Given the importance of capital recovery to total telephone company operations and the sizeable depreciation reserve deficiency, the utilization of proper and uniform depreciation rates and methods at both the interstate and intrastate levels has become "critical if the proper incentives are to be created to insure that the marketplace will function efficiently to bring the benefits of competition to the ratepayers of this country." *1983 Preemption Order,* 92 F.C.C.2d at 874. Improper accounting and depreciation rules would deprive the public of the benefits of advances in communications and serve to "stifle innovation and inhibit the introduction of new technology." *Property Depreciation,* 83 F.C.C.2d at 281. Varying state accounting methodologies which do not accurately reflect both the current measure of the consumption of capital and make provision for the costs of the capital unrecovered through depreciation charges would result in such inadequate and untimely capital recovery. *Id.* at 271-72. This improperly timed capital recovery would prevent telephone companies from offering their services at competitive prices, deprive the companies of badly needed internally generated funds, discourage investment

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[13]The economic life of many telephone company capital assets has been reduced as a result of technological change and competition. Even though this plant may be serviceable from an engineering standpoint, from an economic standpoint replacement is required in order to avoid unreasonably high rates and to ensure the availability of new services. The value of telephone plant has therefore diminished faster than it would in the monopoly environment and faster than the carriers have been permitted to depreciate.

[14]Gold, *The $26 Billion Solution,* Forbes 40-41 (July 29, 1985).

[15]*NTIA Report, supra* note 3, at 142.

in the companies, and increase their overall cost of capital. Underdepreciation would also constrain the introduction of new technology and conversion to new plant, and restrict the maintenance and improvement of existing services and the provision of new services.[16]

Prevented from providing modern services at reasonable rates, the telephone companies will find their larger customers bypassing the local telephone network.[17] Faced with uncertain outside capital markets and a corresponding inability to generate sufficient funds internally, the companies would be forced to delay plant modernization and load even higher depreciation expenses on remaining small business and residential customers.

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[16]*See* Fogarty, *supra,* at 14-15. *See also* the FCC's *1983 Preemption Order* where it concluded that "it is possible that improper capital recovery could delay or prevent modernization which would add to the costs borne by ratepayers and could, ultimately, threaten carriers' ability to fully recover their invested capital." 92 F.C.C.2d at 877. This fact was recognized at least in the past by petitioner NARUC:

> The regulatory body prescribing [depreciation] rates is thus confronted with a decision which affects both the short-run and the long-run interest of the customer who pays rates for utility service. If the commission consistently prescribes depreciation rates below the lower limit of the zone of reasonableness, this results immediately in lower revenue requirements. But in the long run the requirements for income taxes and return more than offset the apparent saving in depreciation expense, so that rates for service must be higher than if the depreciation rates had been more adequate. If the depreciation rates are set so low as to fail to repay the capital invested in a group of property by the end of its service life, confiscation takes place or the unpaid cost remains in the rate base permanently. If, on the other hand, the regulatory body takes a liberal view of the probable service life of the property and establishes depreciation rates toward the middle or high side of the zone of reasonableness, rates for service will be higher in the short run, but in the long run may be lower.

NARUC Depreciation Manual, supra, at 33.

[17]"Bypass" has been defined as the use of communications facilities or services (video, voice, or data) which circumvent the public switched network. *MTS & WATS Market Structure,* 93 F.C.C.2d 241, Appendix F

(footnote continued)

It was in response to this clear threat to its policy of promoting network efficiency and modernization that the FCC adopted the *Property Depreciation* order in Docket No. 20188. Although the Commission had inherited the ICC's plenary authority over telephone company capital recovery, *1983 Preemption Order*, 92 F.C.C.2d at 870-73, the exercise of its full authority was unnecessary prior to the development of the present environment. However, in August 1980 the FCC Staff determined that a "substantial deficiency" existed in telephone carrier depreciation reserves. *FCC Depreciation Primer, supra*, at 32. Three months later, after a seven year investigation, the FCC adopted regulations approving new depreciation methodologies. The FCC's action was based on its conclusion that telephone plant service lives had shortened substantially over previous estimates and that as a result, past allocations of capital recovery had been inadequate. *Property Depreciation*, 83 F.C.C.2d at 289-91. Moreover, the FCC found that if corrective action was not taken, future carrier reserves would not be adequate. *Id.* at 289-90. The Commission determined that to ensure that telephone carriers received capital recovery which more accurately matched consumption, it would be necessary to approve the use of the equal life group (ELG)[18] and remaining life[19] depreciation

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(1983). In a recent study, USTA determined that 35.9% of the telephone industry's monthly access revenues, 40.5% of its business customer base, and 21% of its residential customer base were vulnerable to bypass. United States Telephone Association, *Bypass Study* 2 (Oct. 5, 1984).

[18]ELG, or the unit summation method, is a method which groups plant by combining all units within each vintage group which share an equal life expectancy and is designed to depreciate 100 percent of the original cost of each plant unit over its life. *Depreciation Rates*, 96 F.C.C.2d 257, 259 (1983). In contrast, SLVG makes no attempt to adjust depreciation to allow for reserve surpluses or deficits resulting from the cumulative over or underestimation of life and salvage factors. It is a form of decelerated depreciation which shifts a disproportionate amount of the capital recovery burden to longer-lived plant. *See FCC Depreciation Primer, supra*, at 15-16.

[19]The remaining life methodology approved by the FCC is designed to distribute the unrecovered cost of a group of assets over its estimated average future life expectancy. *Property Depreciation*, 83 F.C.C.2d at 280. The remaining life method differs from whole-life methodology in that the method attempts to ensure that the costs of an asset are recovered during its life time while the whole-life method does not. Although the whole-life method arguably worked in the precompetitive environment, it failed as competition

(footnote continued)

methods to replace the previously employed SLVG and the whole-life depreciation methods. *1983 Preemption Order*, 92 F.C.C.2d at 876. The FCC concluded that the use of these methods: (1)would enhance the companies' cash flow and present a more accurate and objective financial picture of the companies' operations and capital requirements and (2)would promote a substantial federal interest by making possible the accomplishment of the Commission's mandate under Section 1 of the Communications Act through the encouragement of innovation and the introduction of new technology. *Id.* at 878 (citing 47 U.S.C. § 151).

As a consequence, adequate and timely capital recovery is essential to the implementation of the national policy of promoting the efficient operation of the interstate network if continued technological innovation is not to be stiffled and the introduction of new technology not to be inhibited.

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took root because it was no longer possible to fully compensate telephone companies for errors in the estimates of service lives. *Id.*

II. UNDER ESTABLISHED LAW FCC PREEMPTION OF INCONSISTENT STATE DEPRECIATION PRESCRIPTIONS IS VALID

Subsequent to its adoption of the *Property Depreciation* order and faced with mounting state refusal voluntarily to adopt complementary depreciation rates,[20] the Commission reluctantly determined that divergent state depreciation rates and methodologies would have a significant negative impact on telephone company operations because of the tremendous amount of plant involved, and would, as a result, frustrate the accomplishment of federal objectives. *1983 Preemption Order* at 879-80.[21]

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[20]Many state regulators opposed the capital recovery reform measures embodied within Docket No. 20188 from its inception. *See Property Depreciation*, 83 F.C.C.2d at 278-79. These same regulators have, in public forums, espoused their general belief that the depreciation methods available to the telecommunication industry prior to Docket No. 20188 were sufficient for achieving complete captial recovery. Several of these same State Commissions ultimately refused to implement the depreciation method reforms ordered by the FCC in Docket 20188. *See 1983 Preemption Order*, 92 F.C.C.2d at 877 n.14. It seems likely that if FCC authority is overturned these same commissions will return to the archaic and obsolete methods applied before the improvement ordered in the *Property Depreciation* order.

[21]Petitioners have misconstrued the significance of the Commission's *1982 Preemption Order* which was reversed in the *1983 Preemption Order*. *See, e.g.*, Louisiana Brief at 41. The *1982 Preemption Order* was adopted by a bare majority of the Commission. Moreover, two of the dissenting Commissioners strenuously argued that the FCC did have the authority to preempt the states, that it had intended to preempt the states, and that such preemption was required because state objections threatened to imperil and frustrate "important interests of national communications policy." *1982 Preemption Order*, 89 F.C.C.2d at 1109-11 (quoting *North Carolina Utilities Commission* v. *FCC*, 552 F.2d at 1047). Further, implicit in the majority's reasoning was the assumption that "most state commissions have followed most accounting and depreciation procedures prescribed by this Commission in the past," *id.* at 1097, and that as a result, state regulation was reconcilable with federal policies. 89 F.C.C.2d at 1108. However, on reconsideration of its legal authority, and faced as well with the potential frustration of its policy resulting from inconsistent state regulation, a unanimous Commission adopted the *1983 Preemption Order* at issue here.

The broad authority of the FCC to preempt state regulation which is inconsistent or in conflict with the achievement of federal regulatory objectives has been upheld frequently. *See, e.g.*, *United States* v. *Midwest Video Corp.*, 406 U.S. 649 (1972); *United States v. Southwestern Cable Co.*, 392 U.S. 157 (1968). The most recent example is the Court's unanimous decision in *Capital Cities* which held emphatically that, "if the FCC has resolved to pre-empt an area of... regulation and if this determination 'represents a reasonable accommodation of conflicting policies' that are within the agency's domain, we must conclude that all conflicting state regulations have been precluded." *Capital Cities*, 104 S. Ct. at 2701 (quoting *United States* v. *Shimer*, 367 U.S. 374, 383 (1961)).

The Court's decision in *Capital Cities* arose in a context directly analogous to the present case, *i.e.*, where a state's conflicting regulatory action interfered with the FCC's efforts to establish a uniform national telecommunications policy—in that case, with respect to cable television. 104 S. Ct. at 2703. Similarly, state actions under scrutiny here squarely conflict with federal policies governing the most essential of our telecommunications resources, the telephone industry. As was true in the Oklahoma case, the effect of the state regulation at issue here is to subject communications service providers to inconsistent state and federal orders. Moreover, the states' actions impede the FCC's efforts to implement a consistent and effective national policy. Thus, it is entirely appropriate in this case to apply the Court's mode of analysis employed in *Capital Cities*, and to reach the same conclusions.

In *Capital Cities*, the Court expanded upon the reasoning applied in *Fidelity Federal Savings & Loan Ass'n* v. *De La Cuesta*, 458 U.S. 141 (1982), where it had held that state regulation is superseded when the federal agency entrusted with administering a Congressional act intended to preempt conflicting state regulation and such preemptive action was within the scope of the agency's authority. *Id.* at 154. In applying this principle, the Court's resolution of the federal preemption question in *Capital Cities* rested upon affirmative findings with respect to five discernible factors: (1) whether the FCC had expressed its clear intent to preempt the area of regulation in question, *Capital Cities*, 104 S. Ct. at 2700-02; (2) whether the FCC's preemptive action furthered an important federal interest, fell within its statutory

grant of authority, and was aimed at the achievement of its statutory responsibilities and objectives, *Id.* at 2700-01, 2703-04, 2702-08; (3) whether the FCC's decision to preempt conflicting state regulation reflected a "pragmatic effort to harmonize state and federal powers' within the context of the issues and interests at stake," *Id.* at 2708 (quoting *California Retail Liquor Dealers Ass'n* v. *Midcal Aluminum, Inc.*, 445 U.S. 97, 109 (1980)); (4)whether the state regulation under scrutiny conflicted with specific federal regulations or rulings, *Id.* at 2703-05; and, (5)whether the accomplishment of FCC regulatory policies and statutory goals was frustrated by the conflicting state regulation at issue, *Id.* at 2705-09. Analysis of the FCC preemptive action at issue here, in light of these five factors, makes it clear that it is appropriate to preclude the states from prescribing depreciation rates and practices which conflict with the FCC's prescriptions.

A. The FCC Has Unambiguously Expressed Its Intent To Preempt Inconsistent State Regulation Of Depreciation Rates And Practices

There is no doubt concerning the FCC's intent to preempt inconsistent state regulation governing depreciation methods and classes of depreciable property—that intent was explicit and unmistakable. *VSCC*, 737 F.2d at 393. Recognizing that uniform application of capital recovery policies is necessary to its goal of an efficiently functioning competitive telecommunications marketplace, the FCC unequivocally held that, "we find that this Commission's depreciation policies and rates, including the expensing of inside wiring, preempt inconsistent state depreciation policies and rates." *1983 Preemption Order*, 92 F.C.C.2d at 880. The Commission's unambig uous expression of its intention to preempt clearly distinguishes this case from the *Hillsborough* case relied on by the petitioners. *Hillsborough County* v. *Automated Medical Laboratories, Inc.*, 105 S. Ct. 2371 (1985) (which involved an ordinance of Hillsborough County, Florida).

B. Federal Preemption Is Justified Because It Furthers An Important Federal Interest, Falls Within The Scope Of The FCC's Statutory Grant Of Authority And Advances The FCC's Statutory Goals

As the Court in *Fidelity Federal* stressed, "[p]reemption may be either expressed or implied, and 'is compelled whether Congress' command is explicitly stated in the statute's language or implicitly contained in its structure and purpose.'" *Fidelity Federal*, 458 U.S. at 152-53 (quoting *Jones* v. *Rath Packing Co.*, 430 U.S. 519, 525 (1977)).

Analysis of the Commission's action in terms of the factors used in *Capital Cities*, 104 S. Ct. at 2700-01, 2701-04, 2705-06, compels the conclusion that FCC power to preempt conflicting state depreciation regulation is implicitly conferred upon the Commission pursuant to its broad statutory mandate under Section 1 of the Communications Act *(see VSCC*, 737 F.2d at 390, 394-96 (FCC's broad jurisdiction under Section 2 of the Act); *see also North Carolina Utilities Commission* v. *FCC*, 537 F.2d 787, 792-96 (4th Cir. 1976), *cert. denied*, 429 U.S. 1027 (1976) ("*NCUC I*"), and the FCC's express authority over depreciation, Section 220(b).[22] While the Communications Act contemplates complementary federal and state regulation in limited circumstances, *see* 47 U.S.C. 152(b), the FCC is given ple-

[22]FCC power to preempt conflicting state regulation of depreciation is also explicitly set forth in Section 220(b) of the Communications Act of 1934, 47 U.S.C. 220(b). Section 220(b) mandates preemption in plain, unequivocal language: that the Commission "shall" make depreciation prescriptions as to classes of property and rates of depreciation, and that carriers "shall not" charge to operating expenses any depreciation charges that are different from those prescribed by the Commission. The FCC found:

> Taken as a whole, the language of Section 220 appears clearly to preempt the states in connection with depreciation expense determinations and the related accounting. The language strongly implies that the states may not depart from depreciation rules prescribed by the FCC unless the Commission in its discretion allows them to do so. Otherwise, the federal statute would govern state depreciation practices in form only. . . .

1983 Preemption Order, 92 F.C.C.2d at 869-70.

nary and comprehensive jurisdiction over interstate and foreign communications services and facilities and the terms and conditions upon which such services and facilities are offered to the public. As a result, the courts have repeatedly recognized that FCC regulations preempt any contrary state regulations where the efficiency of the national communications network is at stake. *VSCC*, 737 F.2d at 390. As the Court of Appeals for the District of Columbia Circuit recently held, "[i]f the [Communications] Act's goal of providing uniform efficient service is ever to be realized, the Commission must be free to strike down the costly and inefficient burdens on interstate communications which are sometimes imposed by state regulation." *National Association of Regulatory Utility Commissioners* v. *FCC*, 746 F.2d 1492, 1501 (D.C. Cir. 1984) ("NARUC"). *See also Computer & Communications Industry Ass'n* v. *FCC*, 693 F.2d 198, 214 (D.C. Cir. 1982), *cert. denied*, 461 U.S. 938 (1983) ("CCIA"); *North Carolina Util. Comm'n* v. *FCC*, 552 F.2d 1036 (4th Cir. 1977), *cert. denied*, 434 U.S. 874 (1977) ("NCUC II"). It is clear, moreover, as Judge Burger stated in *General Telephone Company* v. *FCC*, 413 F.2d 390, 401 (D.C. Cir. 1969) *cert. denied*, 396 U.S. 888 (1969), that "fifty states and myriad local authorities cannot effectively deal with bits and pieces of what is really a unified system of communication."

The Commission adopted depreciation "policies that will engender a dynamic, efficient telecommunications marketplace with services being provided at reasonable prices." *1983 Preemption Order*, 92 F.C.C.2d at 877. Thus, as the Fourth Circuit held in the *VSCC* decision, "the regulatory action taken by the FCC was also within its authority to ensure efficient operation of the interstate telephone network." *VSCC*, 737 F.2d at 394. Moreover, "the FCC's decision to preempt inconsistent state depreciation practices emerges as a reasonable one, designed to foster the statutory goal [mandated by Section 1 of the Act] of an efficient nationwide telecommunications service." *VSCC*, 737 F.2d at 396.

C. The FCC's Decision To Preempt Conflicting State Depreciation Practices And Rates Represents A Reasonable Accommodation Of Federal And State Powers And Interests

In its *1983 Preemption Order*, the FCC carefully analyzed the

relationship between its authority to prescribe depreciation rates and practices and the powers granted the states under the Communications Act to regulate intrastate communications. Observing that "we do not seek controversy unless it is necessary to protect vital federal interests," 92 F.C.C.2d at 874, and relying on established law interpreting its statutory charter, the FCC concluded that federal preemption of inconsistent state depreciation methods was consistent with the structured dualism between federal and state powers under the Act. *See Capital Cities*, 104 S.Ct. at 2707-08 (quoting *California Retail Liquor Dealers Assn.* v. *Midcal Aluminum, Inc.*, 445 U.S. 97, 109 (1980)).[23] In its pragmatic effort to harmonize federal and state powers under the Communications Act, the FCC was upheld by the Fourth Circuit in rejecting the same argument as is currently under consideration, that under Sections 2(b)(1) and 221(b) of the Act, 47 U.S.C. §§ 152(b)(1) and 221(b), the states alone have the right to prescribe depreciation rates for intrastate regulatory purposes. The Commission ruled that the "setting of depreciation rates is not an essentially local incident or practice" but, rather, "has substantial effects upon the administration and development of the interstate telephone network." *1983 Preemption Order*, 92 F.C.C.2d at 875 (footnote omitted). The FCC stressed that while the states have an interest in preserving their authority over intrastate ratemaking, the federal interest in the creation of an efficient, competitive nationwide communications marketplace was paramount, especially since the FCC's prescription of depreciation left intact the remainder of the states' ratemaking authority.[24]

[23]Throughout the course of the depreciation proceedings, the FCC attempted to harmonize federal and state interests. *See, e.g.*, *1982 Preemption Order*, 89 F.C.C.2d at 1097. Because of state resistance, the FCC was forced to take preemptive action. *See VSCC*, 737 F.2d at 394-95.

[24]The states have retained the most important aspects of their ratemaking function: the power to approve rates, create subsidies, and exercise control over the rate base and rate of return. 92 F.C.C.2d at 874-76. The state commissions have actually conceded this point below where they stated that:

> the preemption order affects neither the myriad of other factors affecting the total revenue requirement, which must be derived from the aggregate of individual prices, nor the prices for individual services (rate design).

Brief of Petitioner Virginia State Corp. Commission at 37, *VSCC* v. *FCC*, 737 F.2d 388 (4th Cir. 1984) (joined *inter alia* by the Ohio, Florida, and California commissions).

Thus, as the Court held in *Capital Cities*, "[w]hen this limited interest is measured against the significant interference with the federal objective"—in this case, of ensuring the proper development of the nationwide telecommunication network—"it is clear that the state's interest is not of the same stature as the goals identified in the FCC's rulings and regulations." 104 S.Ct., at 2709. The Fourth Circuit's conclusion that the FCC action was a reasonable accommodation of federal and state concerns, *VSCC*, 737 F.2d at 394-95, brings this case squarely within the logic of *Capital Cities* and must lead to the same result— upholding federal preemption.

D. The Accomplishment Of FCC Regulatory Objectives Is Frustrated By Inconsistent State Regulation Of Depreciation

Inconsistent state regulation of depreciation rates and methodologies would create an intolerable tension and undermine the achievement of an important federal policy the goal of which is the development of "a dynamic, efficient telecommunications marketplace with services being provided at reasonable prices." *1983 Preemption Order*, 92 F.C.C.2d at 877. Given the importance of capital recovery to the accomplishment of federal objectives, continuation of the past policies of deferred recovery and federal acquiescence to inconsistent state regulation are not appropriate. Since complete and timely recovery of capital cannot be assured except through the use of consistent methodologies, conflicting regulation adopted by many of the states would impede the prompt recovery of capital, result in a worsening of the capital recovery reserve deficiency problem and stand as an obstacle to the accomplishment and execution of the full purposes and objectives of Congress. *See VSCC*, 737 F.2d at 393.

Interstate and intrastate depreciation methodologies are no longer separable. As the Court of Appeals emphasized in the *VSCC* opinion:

> While it may be true that the effects of depreciation policies are more attenuated than the very direct effect produced by physical connection of equipment to interchangeable lines, *it cannot be said that depreciation policies are "separable from" interstate communications. Indeed, the conduct and development of interstate communications would undoubtedly be affected by the states' imposition of depreciation policies that slowed capital recovery and innovation.*

Id. at 395 (emphasis added).

Consequently, California's argument that there is no substantial conflict between inconsistent federal and state regulation of depreciation rates and methodologies must be dismissed. *See California Brief* at 31-34.[25] Since approximately 75 percent of exchange plant is allocated to the intrastate jurisdiction,[26] if, as a result of inadequate state depreciation rate prescriptions, "that large amount of equipment investment should fail properly to reflect its true, rapid depreciation, interstate service would then suffer the effects of delayed innovation." *VSCC*, 737 F.2d at 395; *see also, 1983 Preemption Order*, 92 F.C.C.2d at 876.[27] Moreover, state action attempting to prevent carriers from

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[25]California's arguments that state regulators can be depended upon to ensure that companies receive adequate capital recovery, California Brief at 36, and that past state depreciation policies (albeit in conjunction with federal policy) in no way discouraged technological innovation, *id.* at 37, must also be dismissed as not reflective of historical reality. *See, e.g., NTIA Report* at 136-39. The fact that FCC action was necessary belies this argument.

[26]The proportion of the plant allocated to the intrastate jurisdiction is not significant in determining whether the FCC possesses the authority to preempt. A similar proportion of customer premises equipment had been allocated to the intrastate jurisdiction using similar procedures. *Second Computer Inquiry*, 77 F.C.C.2d at 441-42. However, in the face of overriding federal policy such allocation did not thwart federal preemption. *See CCIA*, 693 F.2d at 214.

[27]NTIA reached a similar conclusion:

> There is substantial potential for frustration of Federal policies should states successfully resist FCC or court mandates on depreciation recovery for future investment. ... Changes in depreciation policy are crucial to the ability of the local telephone companies to meet competition. New competitors do not have large depreciation reserve deficiencies. Most of them are unregulated and can select the most beneficial depreciation schedules allowed by Federal tax laws. By failing to make reasonable depreciation prescriptions, state regulators stimulate and strengthen competitive threats to the their [sic] local exchange companies.

NTIA Report, supra note 3, at 139-40.

utilizing FCC depreciation prescriptions would place substantial burdens on carriers and impair their ability to raise the investment capital necessary to fully compete in the evolving competitive telecommunications marketplace. *See 1983 Preemption Order*, 92 F.C.C.2d at 877. Such results would clearly "stand as an obstacle to the accomplishment and execution of the full purposes and objectives" of federal policy. *VSCC*, 737 F.2d 393 (quoting *Fidelity Federal*, 458 U.S. 141 (1982)). Further, as was demonstrated by appellant Louisiana, the federal-state conflict is both real and significant. Louisiana Brief at 16-17. Thus, to allow the states to prescribe depreciation methodologies inconsistent with those prescribed by the FCC would have an undesirable hindering effect and must, therefore, be considered "barred by the Supremacy Clause." *Capital Cities*, 104 S. Ct. at 2709.

III. FEDERAL REGULATORY POLICY WOULD BE THROWN INTO DISARRAY IF THE COURT FINDS THAT FCC PREEMPTION IS IMPROPER IN THIS CASE

The Commission in recent years has been forced to preempt state regulation in order to safeguard its efforts to promote the provision of modern, efficient nationwide communication service at reasonable rates and the provision of new technologies and services to the public. The Courts of Appeals have consistently upheld FCC preemption, including preemption affecting intrastate rates, where important matters of federal policy are involved. For example, the Court of Appeals upheld FCC preemption of state regulation of enhanced telecommunications services, as a result of which state commissions are precluded from setting rates for these services. *See CCIA*, 693 F.2d at 209-11. Such preclusion also affected local service rates by preventing the use of enhanced service revenues to subsidize local rates. Nonetheless, the Court of Appeals found the FCC's actions to be a valid exercise of the agency's statutory authority which furthered important federal policy goals.

In many of the cases where the FCC's authority to preempt state regulation has been challenged, the states have offered an argument identical to that presently under consideration, *i.e.*, that the FCC's

action is precluded by Section 2(b) of the Communications Act, 47 U.S.C. § 152(b), which reserves to the states the authority to regulate intrastate rates.[28] The Courts have consistently rejected this argument.

For example, in *CCIA* the District of Columbia Circuit held that Section 2(b) did not bar federal preemption merely because preemption of state regulation of terminal equipment and enhanced services affected state ratemaking. There, the FCC had determined that, in order to establish a competitive market for customer premises equipment that was used for both interstate and intrastate purposes, the equipment had to be severed from transmission rates and removed from tariff regulation at both federal and state levels. 693 F.2d at 215.

Clearly, the severance of equipment from transmission rates had a tangible impact on ratemaking, since revenues from terminal equipment could be used to subsidize local rates. The Court of Appeals recognized, however, that the FCC's action was necessary to the furtherance of its policy goals and rejected the states' argument that preemption was improper, holding that there is no statutory basis for distinguishing between ratemaking and other regulatory functions in drawing the lines between federal and state authority. *CCIA*, 693 F.2d at 216.

Even in instances which impinge upon the states ratemaking authority, arguably to a more significant degree than in the situation under scrutiny here, where depreciation affects only a single element in the ratemaking equation, the Courts of Appeals have consistently upheld federal preemption.[29]

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[28]Section 2(b) of the Act provides in pertinent part, that the FCC has no jurisdiction "with respect to (1) charges, classifications, practices, services, facilities, or regulations for or in connection with intrastate communication service by wire or radio of any..." 47 U.S.C. 152(b)(1).

[29]*See, e.g.*, *NCUC I*, 537 F.2d 787 (preemption of inconsistent state regulation of terminal equipment interconnection affirmed); *NCUC II*, 552 F.2d 1036 (FCC terminal equipment registration program affirmed); *Puerto Rico Tel. Co.* v. *FCC*, 553 F.2d 694 (1st Cir. 1977) (FCC declaratory order that although Puerto Rico Telephone Company was a "connecting" carrier it was bound by interstate tariff affirmed); *New York Telephone Co.* v. *FCC*, 631 F.2d 1059 (2d Cir. 1980) (FCC jurisdiction over local exchange service

To determine, as urged by the appellant and petitioners, that the FCC's preemption of depreciation rates is an improper encroachment upon the states' ratemaking authority, would place in question the jurisdictional premises of the FCC's ruling in the terminal equipment case and those other areas where the FCC's policy made it necessary to preempt contrary state regulation. Thus, a result that FCC preemption is not appropriate here, where the FCC's actions have an indirect and attenuated impact on state ratemaking authority (VSCC, 737 F.2d at 395), would throw the entire new scheme of federal regulation into disarray. States once again will assert authority over telecommunications equipment and service offerings which have been deregulated for a substantial period of time.

Such a result would have a negative impact on the future development of federal policy. It would suggest that the FCC is precluded from implementing policies aimed at procuring benefits for telecommunications consumers nationwide if, in so doing, the FCC affects even slightly intrastate revenue requirements. Under its Section 1 mandate, the FCC is striving to establish the structure for a modern nationwide telecommunications network. To do so, the Commission must be able to implement a cohesive national regulatory scheme. A Court decision reversing the Fourth Circuit's holding would severely impair the development of a modern nationwide system of communications—an especially egregious result in light of the disruptions already experienced since divestiture of AT&T—an act which has created an even greater need for a cohesive national regulatory policy governing the future of the telecommunications industry. Thus, the Court must consider its action in this case in terms of that decision's impact on the FCC's ability to oversee the development of one of this nation's most vital resource—telecommunications.

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when used in connection with interstate foreign exchange and common control switching arrangement services affirmed); *Fort Mill Telephone Co.* v. *FCC*, 719 F.2d 89 (4th Cir. 1983) (FCC authority over terminal equipment interconnection upheld); *NARUC*, 746 F.2d 1492 (FCC authority over use of intrastate WATS service to complete interstate communications affirmed); *California* v. *FCC*, 567 F.2d 84 *(D.C. Cir. 1977), cert. denied*, 434 U.S. 1010 (1978) (FCC jurisdiction over regulation of foreign exchange and common control switching arrangement facilities affirmed, where facilities used for both interstate and intrastate service).

CONCLUSION

The court below, properly applying the standards established by this Court, correctly determined that the FCC acted within the scope of its authority in preempting inconsistent state regulation of depreciation practices and rates. Both precedent and national policy dictate that the lower court be affirmed.

Respectfully submitted,

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